

EXECUTIVE SECRETARIAT

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Remarks:

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Executive Secretary
10/17/82
Date

NSC review completed.

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THE WHITE HOUSE
WASHINGTON

Executive Registry

82-12385

CABINET AFFAIRS STAFFING MEMORANDUM

DEC- 8/49/82

DATE: 10-7-82 NUMBER: 077526CA DUE BY:

SUBJECT: Cabinet Council on Economic Affairs - Friday, October 8, 1982

11:00 a.m. - Roosevelt Room

	ACTION	FYI		ACTION	FYI
ALL CABINET MEMBERS	<input type="checkbox"/>	<input type="checkbox"/>	Baker	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Vice President	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Deaver	<input type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Clark	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Darman (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Defense	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Harper	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Attorney General	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Jenkins	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Interior	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Wheeler	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Agriculture	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Kudlow	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Commerce	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
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HHS	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
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Counsellor	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
OMB	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
CIA	<input type="checkbox"/>	<input checked="" type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
UN	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
USTR	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CCCT/Gunn	<input type="checkbox"/>	<input type="checkbox"/>
CEQ	<input type="checkbox"/>	<input type="checkbox"/>	CCEA/Porter	<input checked="" type="checkbox"/>	<input type="checkbox"/>
OSTP	<input type="checkbox"/>	<input type="checkbox"/>	CCFA/Boggs	<input type="checkbox"/>	<input type="checkbox"/>
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REMARKS: The Cabinet Council on Economic Affairs will meet Friday, October 8, at 11:00 a.m. in the Roosevelt Room. The agenda and background papers are attached.

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☒ Becky Norton Dunlop
Director, Office of
Cabinet Affairs
456-2800

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THE WHITE HOUSE

WASHINGTON

October 6, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER *RBP*

SUBJECT: Agenda and Papers for the October 8 Meeting

The agenda and papers for the October 8 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 11:00 a.m. in the Roosevelt Room.

The Council is scheduled to review financial market developments and monetary policy from three perspectives. First, Beryl Sprinkel, Under Secretary of the Treasury for Monetary Affairs, has prepared a paper on a "Financial Strategy for Reducing Inflation and Interest Rates."

William Poole, newly appointed as a member of the Council of Economic Advisers, has prepared a paper on "Expectations in the Financial Markets."

Lawrence A. Kudlow, OMB Associate Director for Economics and Planning, is preparing a paper reviewing recent financial market developments which will be circulated on Thursday, October 7.

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

October 8, 1982

11:00 a.m.

Roosevelt Room

AGENDA

1. Financial Market Developments (CM#111)



THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D.C. 20220

October 6, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

From: Beryl W. Sprinkel *BWS*
Subject: Financial Strategy for Reducing Inflation
and Interest Rates

President Reagan's Economic Recovery Program was designed to provide a long-term solution to the chronic problem of a stagnating, inflationary economy. The economy is now in a period of transition from an inflationary path, which impedes real economic growth, to one of price stability, which promotes sustainable economic growth.

While attention is understandably focused on the current situation of high unemployment, interest rates and sluggish economic activity, proposed solutions often lose sight of longer-term objectives and realities. Those realities have formed the basis of the economic recovery program.

- (1) Less inflation involves permanently slower growth of nominal income.
- (2) Slower growth of nominal income does not imply or require sustained slowing of growth of real income.
- (3) Slower growth of nominal income requires a slower trend of money growth.

The monetary policy strategy called for a gradual, steady deceleration of money growth over a period of six years. Gradual slowing was intended to reduce the immediate costs of the transition from prolonged inflation. Steady growth was intended to encourage the adjustment of expectations to the long-term goal of achieving noninflationary money growth. Adjusting expectations about long-run inflation is crucial to reducing the immediate costs of disinflation; that is, unemployment and the restriction of economic activity. That adjustment is best enhanced by pursuing credible and consistent noninflationary policies.

However, the implementation of some portions of the general policy has not started off well. The slowing in money growth has been more abrupt than planned. In addition, monetary volatility has retarded the adjustment of inflationary expectations and this

has been reinforced by the prospective budget deficits. These factors have played a significant role in prolonging the adjustment of the economy to the slowing of inflation. This is manifested in the level of interest rates and the halting nature of the economic recovery.

The average rate of monetary expansion has been slowed, however, leading to significant improvement in inflation and interest rates since 1980. The stage is set for a sustained economic expansion, but the outlook continues to depend on achieving a solution to the problem of unconstrained growth in government spending and on further efforts to improve monetary control.

The public debate on economic policy and the economic outlook has become dangerously confused, however, by misunderstanding and misrepresentation of what the program is designed to achieve. At issue are the manner in which policy is implemented, the immediate versus the ultimate effects of policy, factors affecting the economy during the transition to less inflation, and the interaction of the various policy elements, including monetary and budget initiatives. These issues are difficult to disentangle and, unfortunately, simplistic, extreme characterizations are being drawn.

The Administration does not face a "policy failure," requiring a fundamental change in approach. The problems of a sluggish economy over the past year are not as simple as money being too tight, or deficits being too large. Instead, the problems involve correcting those factors which have worked to intensify the immediate stress of disinflation. The conduct of monetary policy is crucial in this regard, but the budget situation is equally important. In any event, success requires that we distinguish between the fundamental, or permanent influence of economic policy actions and the transition from the stagnating, inflationary economy of the late 1970s. Both of these issues will be discussed at this meeting. My purpose is to address the former.

EXECUTIVE OFFICE OF THE PRESIDENT

COUNCIL OF ECONOMIC ADVISERS

WASHINGTON, D.C. 20500

October 8, 1982

MEMORANDUM FOR CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: William Poole

Subject: Expectations in the Financial Markets

My purpose in this memorandum is to examine the current state of the securities markets from the standpoint of the state of market expectations and their implications for government policy. I begin with some background on what is known about expectational processes and then proceed to discuss the current situation.

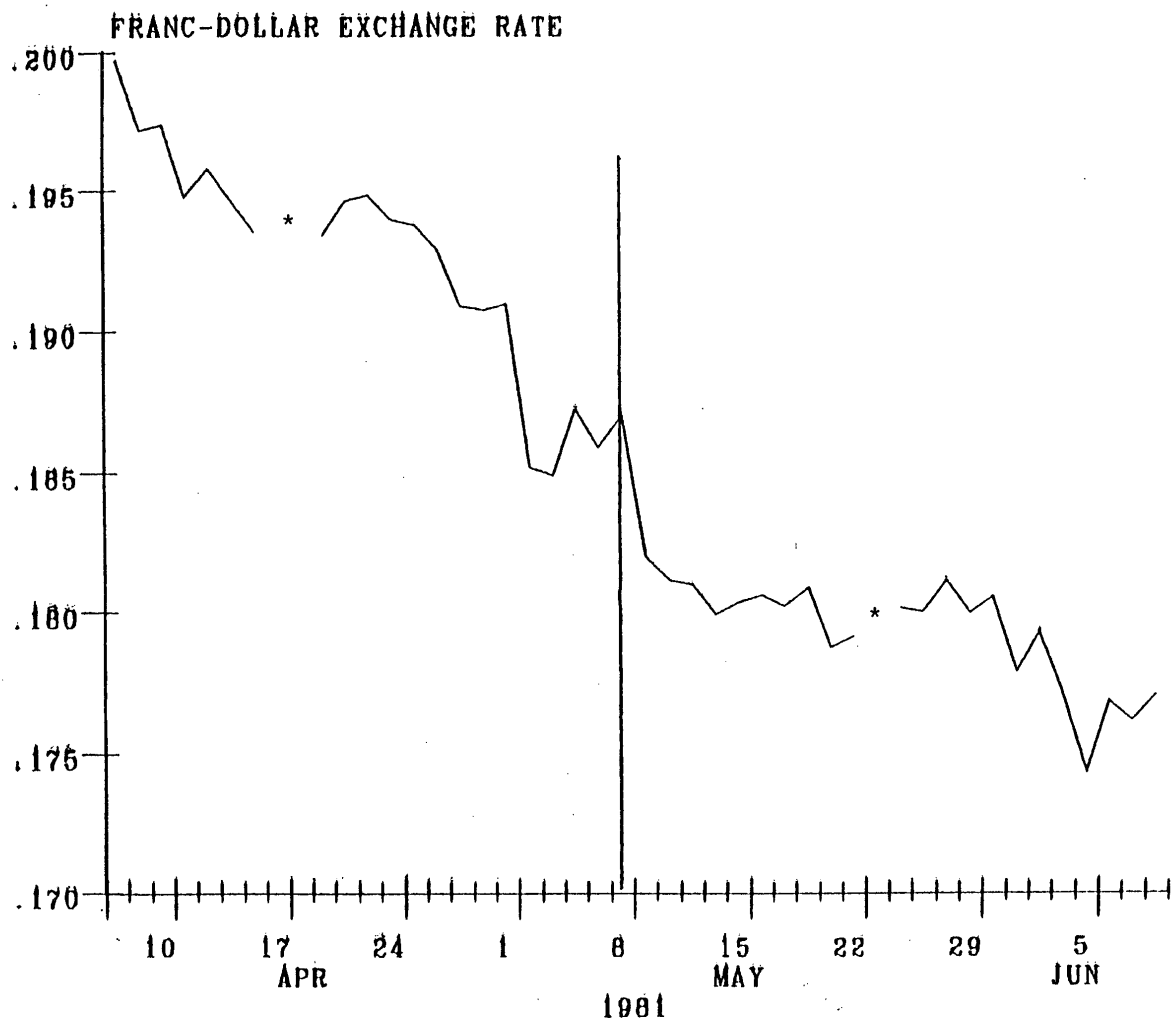
Background

The bond and stock markets, the commodities markets, and the foreign exchange market are all expectational markets. They cannot be understood without understanding expectational processes. And because government policy is so central to the formation of expectations, policy design should never ignore expectational issues.

Some examples. I have selected three clear examples to illustrate three points important to understanding our present situation.

1) The chart on the next page shows the U. S. dollar/French franc exchange rate, daily, on either side of the election of President Mitterrand in May 1981. As so often happens, before any government policies in fact changed, the franc dropped sharply in anticipation of policy changes to come. From what we now know, the market was not wrong, at least in terms of direction. The discrete drop in the franc is consistent with there being no lag in the formation of expectations, a view supported by most modern academic research on securities markets. Situations appearing to display a lag are better interpreted as involving conflicting cross-currents of information.

2) In early November 1978 the Federal Reserve introduced a tighter monetary policy. The policy change appeared especially significant because the Carter Administration, which had earlier been pressuring the Fed to follow easy money policies, was now supporting a tighter policy. (President Carter himself announced the Fed's discount rate increase.)



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The tighter monetary policy produced a textbook expectational reaction. The market expected short-term interest rates to be higher in the near term and lower in the longer term, presumably because the tighter policy would slow the economy and slow inflation in due time. The policy change occurred November 1, 1978; the next day the December 1978 Treasury bills futures contract rose in yield by 32 basis points; the March 1979 contract rose by only 6 basis points, while the rates on the contracts from June 1979 through September 1980 all fell. (The September 1980 contract fell by 22 basis points.) These adjustments in interest rates suggested that the market expected the new monetary policy to work as intended. Interest rates would be higher in the near term and lower later on as the tighter policy lowered the rate of inflation. The policymakers could obviously take comfort in these expectational responses.

3) On October 6, 1979 the Fed adopted its new operating procedures. On October 8, the first trading day after the Fed policy change, interest rates rose on all maturities of both spot securities and futures. For example, the rate on the December 1979 bill futures contract rose by 54 basis points and the September 1981 contract rose by 50 basis points.

Market reaction to this Fed policy change was disquieting. Why should interest rates on all maturities rise in the face of a new policy designed to achieve better control over the money stock and thereby to reduce inflation in the long run? The policy-makers should have interpreted this expectational response as suggesting that further policy actions were needed to convince the markets that the new policy was appropriate.

Rational Expectations. Over recent years economists have argued endlessly over whether expectations are "rational." This argument is of exactly the same genre as arguments over whether markets are "perfect."

For policy purposes all that is necessary is to accept the argument that markets work pretty well, especially as compared to the alternative of having Uncle Sam do it. In the securities markets the evidence is strong that securities are priced very sensibly, even if not perfectly "rationally."

It is essential to understand that in the context of expectational markets, market "rationality" or "efficiency" does not mean that the markets are especially successful in foreseeing the future. All that is meant is that the markets do not make easily avoidable mistakes.

Securities markets since November 1980

The disappointing behavior of the bond and stock markets since November 1980 is well known. The high average level and high volatility of interest rates both deserve discussion.

The level of interest rates. In my opinion, the high level of nominal long-term interest rates since November 1980 can only be interpreted as reflecting a market expectation that the economic policies of this Administration would fail or would be short-lived. The budget deficit and the associated pressure on the bond market through government bond sales may have caused some increase in rates, but a 30-year Treasury bond yield of 13 to 14 percent must reflect expectations of practically permanent budget deficits and/or a long-term inflation rate near the double digit range.

Interest rate volatility. The volatility of interest rates has been as remarkable as their high average level.

To understand what is involved, note first that a 30-year bond reflects a weighted average of the market's expectations of the next thirty one-year interest rates. It is one thing for events to change expectations of the interest rate over the next year or two, but what is remarkable about the last few years is that fleeting events would change expectations of the average interest rate over the next thirty years. Our forecasts of the future are necessarily vague; we usually rely on long-term trends, believing that short-term fluctuations around the trends will average out over time. What are we to make of a 30-year bond rate that rises from 9.81 percent in June 1980 to 12.40 percent in December 1980, or from 12.96 percent in June 1981 to 14.67 percent in September 1981 (monthly average data)?

The explanation for this extreme volatility -- and the volatility has indeed been unprecedented in U. S. experience -- is that expectations today are weakly held and easily swayed by events. The shifting monetary and fiscal policy outlook and shifting political winds have led to repeated revisions of the outlook by the market. Sometimes it looks as though real progress is being made to reduce the deficit; sometimes not. Sometimes it appears that the Fed has finally managed to bring the money stock under control; sometimes not. Sometimes Republican strength with the electorate seems to be building steadily; sometimes it appears likely that the Democrats will win in 1984 and take us back to the policies of the past.

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No objective observer can say that these swings in market sentiment are irrational. The fact of the matter is that this Administration may not in the end be skillful enough, and the electorate patient enough, to reverse in a permanent and decisive way the destructive policy trends of the last 50 years. It is, and will remain for some time, a close call.

Policy Implications

The central role of expectations in the securities markets has three principal policy implications.

1) The market reaction following a policy initiative may provide data indicating whether or not the market believes the initiative will be successful. For example, the foreign exchange market quickly cast a negative vote following the French election in May 1981.

The failure of U.S. long-term interest rates to fall until recently has been most distressing. Thirty years from now we will know whether or not the market was correct. For now, we must live with the market's vote as best we can.

2) Central to changing the market's vote is constancy of purpose and consistency of action. I can say quite honestly that before coming to Washington nine weeks ago I felt that the Administration had been remarkably successful in this regard under very difficult and trying circumstances. In my opinion, the only important failure was a tendency to over-promise in 1981.

As disappointing as the high interest rates have been, the main remedy is patience. Impatience runs the clear risk of destabilizing rather than stabilizing market expectations. Continued patience promises large dividends. If events go our way, as I believe they will, economic recovery will cement a developing market view that this Administration has the correct policies and the guts to see them through. Confidence in the Administration will then be much stronger than it would have been had we appeared to cave in because the pressures were too great.

3) Every opportunity should be taken to introduce new policies that reinforce the basic thrust of existing policies. Similarly, we must fight inconsistent policies.

With respect to monetary policy, I believe that we have been hurt by policy volatility. Fluctuations in

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money growth have been a direct source of disturbance and have in addition contributed to a volatile expectational environment.

The Administration is caught in a double-bind on monetary policy. If we do not put pressure on the Federal Reserve to stabilize its policy money growth is likely to remain volatile. If we do put pressure on the Fed, the market is likely to believe that this Administration, like so many in the past, is pushing the Fed to step on the gas. It is unfortunately true that the market, thinking that it is reading between the lines, will tend toward this latter interpretation no matter how carefully Administration criticisms of Fed policy are phrased.

The Federal budget situation is at least as difficult as the monetary situation. The fact is that the Federal budget, on a current programs basis (both tax and spending programs) has a very large permanent deficit. The market believes that the deficit is unsustainably large, and that the future must bring some combination of tax increases and expenditure decreases.

In this situation the Administration must work to improve the fundamentals of both monetary and fiscal policy. On monetary policy we must continue to support money stock control. We should oppose in vigorous fashion all congressional efforts to require the Fed to target interest rates, long or short, real or nominal. On fiscal policy the key factor must involve credible efforts to reduce spending. In my opinion, the market will not view attempts to close the deficit through further tax increases as convincing. Tax increases did not close the deficit in the 1970's because control over expenditure growth was so weak. If we go the tax route, the market, probably justifiably, will come to the conclusion that we can't control spending.

Summary

The behavior of the securities markets reflects market expectations about future government policies. The current high level of long-term interest rates is not consistent with the policies of this Administration. If we prevail on policy, the market will be proven wrong.

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While some may believe that it is unfair and unreasonable for the markets to have so little confidence in Administration policies, we have no choice but to cope with this market view as best we can. There is, of course, clear evidence that market sentiment is improving and that the Administration is winning. Over the course of this year 30-year Treasury bond yields have fallen from a monthly average of 14.68 percent in February to 12.38 percent in September. That is important and visible progress. But the bond yield would probably have to fall to about 8 percent today to be fully consistent with current policies. It is sobering to realize that with respect to the bond yield we have come less than half way. There are still difficult times ahead.

good